United States Court of Appeals

for the Second Circuit

APPELLANT'S PETITION FOR REHEARING

74-2233

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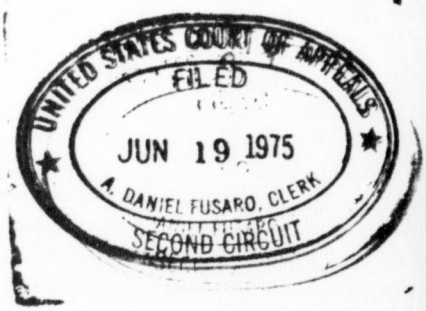

IN THE

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

DOCKET NO. 74-2233

In re

CONTINENTAL VENDING MACHINE CORP.
and CONTINENTAL APCO, INC.,

Debtors.

JAMES TALCOTT, INC.,

Appellant,

IRVING L. WHARTON,

Appellee.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF NEW YORK, JACOB MISHLER, CHIEF JUDGE

APPELLANT'S PETITION FOR REHEARING AND SUGGESTION FOR REHEARING IN BANC

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APPELLANT'S PETITION FOR REHEARING
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PURSUANT TO RULES 35 and 40, FEDERAL
RULES OF APPELLATE PROCEDURE

James Talcott, Inc., Appellant, by its attorneys, hereby petitions for a rehearing of its appeal, argued April 1, 1975 and decided June 5, 1975, with opinion, and, alternatively, hereby suggests to this Court a rehearing in banc. Rules 35 and 40, Federal Rules of Appellate Procedure.

The decision which is the subject of this petition was rendered by a divided panel consisting of Circuit Court Judges Anderson, Mansfield and Oakes. Judge Oakes authored the majority opinion, concurred in by Judge Mansfield, which affirmed an order

of Chief Judge Mishler, United States District Court for the Eastern District of New York, entered on August 12, 1974. Judge Anderson dissented in a separate opinion (3978-3987).

The affirmed order confirmed a plan of reorganization under Chapter X of the Bankruptcy Act over the objection of Talcott, a secured creditor. The main question decided on this appeal is "whether it is 'fair and equitable' under Section 221 of the Bankruptcy Act, 11 U.S.C. Section 621, to disregard corporate lines and consolidate and pool assets and liability for purposes of dealing with unsecured claims but not to do so for purposes of dealing with secured claims" (3972-3973).

A rehearing, either before the original panel or before this Court in banc is here appropriate because: 1) it is appellant's belief that the majority misapprehended a question of law significant to the outcome; 2) consideration by the full Court is necessary to maintain uniformity of its decision; 3) the proceeding involves a question of exceptional importance and is one of first impression; and 4) the decision of the majority is plainly erroneous.

PETITION FOR REHEARING

The majority has misapprehended Talcott's "second major point" (3974-3975). Talcott does not contend that, without consolidation, the broad language of the security agreements "applied to permit the Apco lien to cover the Continental deficit." Talcott contends for this result only by virtue of consolidation.

Point III of Talcott's main brief (p.18) is headed, "A contractual provision such as the one before the court is sufficiently broad to allow, upon substantive consolidation, application of a creditor's security given by one debtor against the indebtedness of another." Similarly, Point II of Talcott's reply brief (p.6) is titled, "Consolidation and the broad dragnet clause afford Talcott a lien upon the 'surplus' lawfully in its possession."

Judge Anderson correctly understood Talcott's argument to be that "its lien on the Apco surplus" covers "the Continental deficit upon consolidation * * ." (3981) He concluded that the "absence of a cross-collateralization provision * * is * * irrelevant" (3984) because consolidation merges the debtors, their assets and liabilities.

It would seem that it is the initial misapprehension of Talcott's argument and the applicable law that has led the

majority to a result on the law contrary to Judge Anderson's formulation substantially in accord with Talcott's argument. For this reason a rehearing is urged as essential.

Moreover, the majority opinion hinges on the assertion that "Talcott's liens were in no way diminished or lien property transferred by virtue of intercompany dealings". (3977) It is the linchpin of affirmance. Any proof to the contrary would seemingly require reversal. There is such proof.

On December 30, 1960, Continental purchased from United States Hoffman Machinery Corporation a group of its subsidiaries known as the "Apco group" and certain other assets for $3,500,000. As part of the purchase price, Continental issued to Hoffman its promissory notes totaling $1,800,000. On January 16, 1961, Talcott discounted these notes and as security therefor and for any other Continental obligations, Continental pledged to Talcott 80% of Apco stock owned by Continental and a secondary security interest in 20% of Apco stock also owned by Continental.

The trustee has contended and Judge Mishler found that Continental manipulated and misused Apco. The intercompany dealings perforce had the effect at least of diminishing and probably destroying the value of Apco stock pledged to Talcott to secure payment of Continental's notes and other indebtedness to Talcott.

The transaction is reflected in a restatement of Talcott's collateral and of the debtors' liability to Talcott as of October 31, 1963. The restatement was authorized and approved by Judge Mishler's order of December 4, 1963. The top-page summary of the restatement is headed "Statement of Direct Liability to James Talcott, Inc. * * as of October 31, 1963". The summary of Continental's liabilities to Talcott lists "Notes in re Apco, Inc. acquisition - $643,500.00".

Attached to the restatement of liability and following supporting schedules is a "Statement of Actual and Provisional Credit Balances held by James Talcott, Inc. to the credit of Continental as of October 31, 1963 and Statement of Collateral with respect to the stock of Apco." It states:

> "Talcott also holds as collateral security certificates of the capital stock of Apco warranted by the depositor of that stock to represent 80% of all outstanding capital stock of Apco. In addition, Talcott holds as collateral a secondary pledge, subject to a primary pledge in favor of others of the remaining 20% of such capital stock of Apco."

The restatement was part of the record on the prior appeal as Document 4. It was referred to in Judge Mansfield's opinion on that appeal, 491 F. 2d 813,817 (1974). Judge Mishler and the trustee have been fully familiar with the

restatement. If the court should feel that more proof is necessary in connection with the Apco stock as an instance of diminution of Talcott's liens resulting from intercompany dealings, then it should remand. Talcott's equities have not been explored. On remand, Talcott will have an opportunity to establish the equity arising from diminution of its lien on Apco stock and such other equities as it may be able to establish twelve years after its transactions with the debtors.

SUGGESTION FOR REHEARING IN BANC

EXCEPTIONAL IMPORTANCE

There has been in recent times an enormous increase of vast intercorporate structures, national and multinational conglomerates. Even on the lower levels of size and economic power, there is hardly a corporation that does not have one or more subsidiaries or affiliates. As common are one-man or family corporations or other closely-knit groups operating as single or multiple corporate units. A characteristic feature of modern corporate business is control and domination of subsidiaries and affiliates by parent corporations and of single or multiple corporations by their principal shareholders and managers.

Inadequate capitalization and cash resources inevitably require financing by banks and modern factors who lend on security. Liens on all or most of the corporate assets are no longer a novelty in corporate financing.

When financial distress brings corporations into court, serious and complex questions arise with respect to judicial administration of multi-unit debtors whose intercompany dealings, transactions and indiscriminate treatment of their respective assets and liabilities have blurred or erased corporate lines. The effect on both secured and unsecured creditors is substantial. The rights and interests involved are large. To achieve the goals of debtor relief, courts, in consolidations, are regularly called upon to balance equities while preserving legal rights. Although the instant case is one of Chapter X reorganization, the question presented and decided arises as well in Chapter XI arrangements and Chapters I through VII straight bankruptcies. The complexity and frequency of the problems posed and the large interests these problems affect make the question involved in this case one of exceptional importance.

Moreover, the question decided is "one really of first impression." (Oakes, J. 3975) The decision will control lower courts in this Circuit. It will bind lower courts in other Circuits in the absence of precedent of their respective Courts

of Appeals. It will be followed or rejected by other Courts of Appeals depending on their assessment of the persuasiveness of this Court's judgment. Rehearing in banc is essential to make as certain as may be that the decision is correct in every way and that it truly represents the considered judgment of the whole Court.

UNIFORMITY OF COURT'S DECISIONS

The majority opinion is in conflict with Chemical Bank Trust Co. v. Kheel, 369 F. 2d 845 (2 Cir. 1966) where, as a result of consolidation, the Government, holding a claim against a corporation with insufficient assets, acquired a claim against the assets of a group of subsidiaries and, by virtue of its right to priority, took practically the entire consolidated estate.

The Court there held that in the "rare case" where the corporations, their assets and liabilities are so hopelessly intertwined as to make it impossible to unscramble them except by large expense of time, effort and money and even then with no assurance of success, consolidation may be ordered without regard to any possible equities of individual creditors. This is done in order "to reach a rough approximation of justice to some rather than deny any to all." (at p.847). That is "the whole thrust of Kheel" (Anderson, J. 3985-3986).

It is agreed that the instant case represents the "rare case" in Kheel (Anderson, J. 3982-3983); yet, the majority would exclude secured creditors, Talcott being the sole one, from consolidation absent proof of detriment to Talcott as a result of intercompany dealings and manipulation (3974).. The majority makes the flat assertion that "Talcott's liens were in no way diminished or lien property transferred by virtue of inter-corporate dealings." (3977).

After noting that this is the majority's "only equitable rationale * * * for distinguishing between secured and unsecured creditors", (3986) Judge Anderson states:

> "But there is no supporting evidence in the record and no finding to this effect * * Moreover, as noted by the Court in Kheel and by the trustee in the instant case, consolidation was properly ordered in this case because it was virtually impossible to reconstruct inter-corporate claims, transaction, liabilities and assets. For these very same reasons Talcott would undoubtedly find it equally impossible to demonstrate that its liens were diminished or lien property transferred even if it occurred. It certainly cannot be asserted with assurance, however, that money loaned by Talcott to Continental, and ostensibly secured, was not in fact turned over to Apco thereby creating the 'deficiency' It seems to me that the assumption underlying the type of consolidation present here and in Kheel is that the indiscriminate manipulation of the debtors was so extensive that neither the trustee nor the bankruptcy court could begin to sort out how each creditor or even classes of creditors were affected, and that <u>all</u> must have suffered, absent proof to the contrary. There is no such contrary proof here."

We submit that the majority has gone far afield, straining to distinguish the instant case from Kheel. Thus, the majority speculates that there was in Kheel "every reason to believe that the Government, as an unsecured creditor, suffered loss because of the indiscriminate shifting of assets between corporations" (3977). The "every reason" is no more than the necessary assumption in a "rare case". For Talcott, proof is required.

Talcott is denied improvement of its position solely because it is a secured creditor. Kheel improved the Government's position, but in the majority's view that was merely because consolidation "simply made more money available for the estate" (3977). This appears to be semantics with no substantive differentiation.

The majority's other distinction between Kheel and the instant case is that the Government there had a statutory priority whereas Talcott asserts a consensual lien (3976). In context the difference is immaterial. No plan can take away the Government's priority, United States v. Key, 397 U.S. 322 (1970). No plan can take away a non-consenting creditor's security. Bankruptcy Act, Section 217(6). In any event, priority and security establish only a claim's rank. The

underlying debt, the claim, is the thing. And the Government's claim, without consolidation, was only against the parent.

In Kheel, the bank argued that the Government "did not bargain for" a claim against the subsidiaries. (Appellant's Brief 23-24). The Government argued it will not "be unfairly benefited by consolidation." (Appellee's Brief 35 and 33-34). The arguments in this case are the same. No differences are perceived between Kheel and this case to compel different results.

PLAIN ERRORS

The majority would bar Talcott from consolidation in the exercise of the court's equitable power of subordination. (3977-3978) The dissent is unanswerable: "But the majority has failed to demonstrate that equitable considerations justify this result in the instant case. * * * There is no indication that Talcott is guilty of any fraud or wrongdoing with respect to Continental, Apco, or any of the other creditors in these proceedings." (3985)

The majority insists that Talcott must not be allowed to obtain more than "it bargained for" (3978). The premise is that Talcott dealt with two separate entities and relied on their respective collateral. There is no proof of such reliance. And, as Judge Anderson noted, separate dealing was "without

knowledge that in fact Continental and Apco were operating as a hopelessly entwined single entity" and "the same can be said for probably most, if not all, of the unsecured creditors." (3985)

The majority overlooks, fails to consider, that upon consolidation all creditors, secured and unsecured, do not get what they bargained for - advantages and disadvantages. Judge Anderson understands this very well. "Although Talcott might secure an advantage through consolidation that it otherwise would not have had, likewise an advantage accrues, solely because of consolidation, to many of the unsecured creditors who otherwise would not have had it" (3986).

The majority gravely errs in viewing consolidation as having occurred in 1971 when Judge Mishler made his findings and approved the plan. The error is fundamental and permeates the majority's entire position. The findings establish the debtors' merger, by their own conduct, some time prior to bankruptcy in 1963; the order merely confirms the operative facts and circumstances long pre-dating bankruptcy.

> "It is clear * * * that the instant consolidation merely confirmed an implied merger of the two debtors which pre-dated the filing of the involuntary petitions. * * * Because in legal effect Continental and Apco were one, prior to the initiation of these proceedings, and Talcott's security agreement with each contained the same broad dragnet clause, it follows that

> at the time the involuntary reorganization petitions were filed, Talcott's security agreements with Continental and Apco were in legal effect, one and the same" (dissent 3983).

The majority's basic error in respect of the time of consolidation necessarily infects all of its legal conclusions. Contrary to the majority's rulings, Talcott did have a lien on the Apco surplus for the Continental deficiency. (Majority 3974; dissent 3987). Talcott was in fact "affected" by the plan within the meaning of Section 107 of the Act. Depriving Talcott of its lien, the plan does "materially or adversely" affect Talcott's interests (majority 3977). The "cram down" provisions of Section 216(7) are fully applicable (majority 3975). The absolute priority rule has not been followed with respect to Talcott (majority 3978). The plan is not "fair and equitable" under Section 221 of the Act (dissent 3978-3979).

The majority has failed to consider Talcott's equities referred to by Judge Anderson (3984-3985, 3986) and it has failed to provide for exploration of Talcott's other equities. (See p. 4-6, supra).

Talcott indeed argues, on the facts and the law, that the improvement of its position is no more than the inevitable consequence of consolidation which improves the position of unsecured creditors - "what is sauce for the goose is sauce

for the gander." As for Talcott's "swallow(ing) the sauce" (3976), it would seem rather more appropriate to say that the court, the trustee and unsecured creditors "want(s) to dance without paying the music." Fitzpatrick v. Commonwealth Oil Company, 285 F. 2d 726, 730 (5 Cir. 1960)

For all the foregoing reasons, there should be a rehearing or a rehearing in banc and on such rehearing, the order appealed from should be reversed or the matter remanded.

Respectfully submitted,

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